**William Housey, CFA**
**Managing Director of Fixed-Income, Senior Portfolio Manager**

William has 25 years of investment experience and has extensive experience in the portfolio management of both leveraged and unleveraged credit products, including senior loans, high-yield bonds, credit derivatives (CDS/LCDS) and work-outs/corporate restructurings. Prior to joining First Trust, William served as Executive Director and Co-Portfolio Manager at Van Kampen Funds, Inc., a wholly-owned subsidiary of Morgan Stanley ("Morgan Stanley/Van Kampen"), where he was a Portfolio Manager of institutional structured products and a Senior Analyst. William previously managed two collateralized loan obligations (CLOs) and an unlevered comingled institutional fund.

## FIXED INCOME MARKET REVIEW

In the first quarter of 2022, as the impact from the Omicron variant was fading, Russia's invasion of Ukraine sent a shockwave through global risk markets. Oil and other commodity prices spiked, further exacerbating existing inflationary pressures. On March 7, 2022 Brent Crude Oil prices reached a high of $134.91 per barrel, levels not seen since 2008. Inflation had already reached 40-year highs with November 2021 CPI registering +6.8% before climbing even higher in February to +7.9%. In response, the Federal Reserve (the "Fed") raised the benchmark short-term rate at the March meeting by a quarter percentage point to a range between 0.25% and 0.50%. The Fed also indicated additional rate hikes were forthcoming with the median dot-plot signaling 7 rate increases in 2022. An increasingly hawkish Fed and the developing conflict in Ukraine contributed to lower investor risk appetite in the quarter as evidenced by equity and bond market volatility. As the bond market priced in more rate hikes for the remainder of the year and into 2023, short-term U.S. Treasury yields spiked, leading the yield curve to flatten with the 2-year vs. 10-year Treasury yield spread inverting during the quarter.

## FIXED INCOME OUTLOOK

Entering this year, our expectation was for tempestuous volatility in the fixed income and equity markets as we believed the Fed's policy shift from unprecedented monetary stimulus to much more hawkish policy in the face of decelerating economic growth and rising inflation would be a catalyst for a risk asset correction and higher interest rates. Moreover, we anticipated interest rates would reset higher on the restrictive rhetoric from the Fed, and concerted action from global Central Banks as they attempt to reign in high prices.

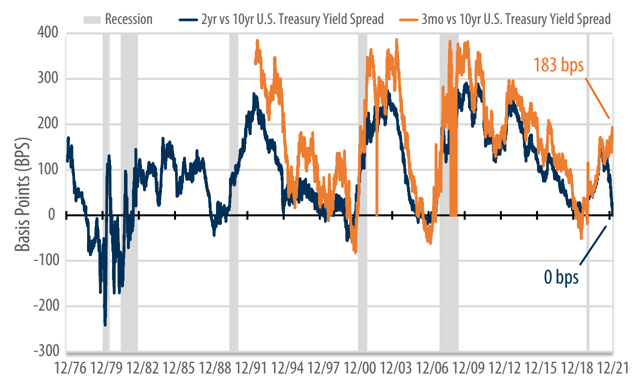
As we enter the second quarter, while global markets will grapple with similar macroeconomic uncertainty, we believe the U.S. economy will grow in 2022, albeit at a significantly slower pace than 2021. Despite this slowing growth, we believe recession risk is limited over the near term. We also believe inflation has not yet peaked and will exceed Fed expectations for a prolonged period. The Fed has become increasingly hawkish and while financial conditions have tightened, monetary policy is nowhere near restrictive.

The bond market has priced in a steady pace of interest rate hikes for the remainder of this year and into next year resulting in a flatter yield curve. The front-end of the yield curve is pricing the expected path of short-term rates while the intermediate part of the curve is pricing in a greater probability of policy error by the Fed. These market expectations briefly inverted several, but not all measures of the yield curve (see Chart 1). While we do not view a modest curve inversion as an ominous recession indicator yet, given there has been only one interest rate hike in this cycle and much of the curve flattening resulted from increasing market expectations rather than actual Fed policy, we will be closely tracking the yield curve, macroeconomic data and corporate fundamentals to validate a recession warning.

As such, we believe that interest rates will continue to increase on the longer part of the curve and expect the curve to steepen in the near term (see Chart 2). Our next target for the 10-year US Treasury is 2.6%, and, if prices sustain that level, our next target is 3%. The Fed fund futures market is now pricing in expectations for ~8 rate hikes for the remainder of this year (see Chart 3). This has made shorter duration assets more attractive, in our view, as the intermediate part of the yield curve is more exposed to the risk that rates reprice higher. We believe that our expectation for elevated inflation supports higher long-term interest rates, creating the potential for asymmetrically negative risks in long duration fixed income assets.

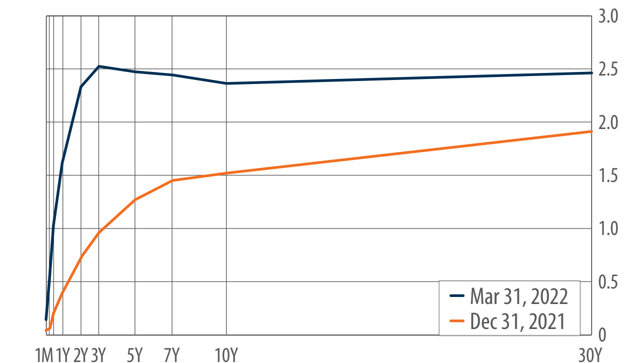
Furthermore, the combination of higher interest rates and geopolitical tensions surrounding Russian's invasion of Ukraine led to wider credit spreads. Given our expectation for continued U.S. economic growth and generally healthy corporate fundamentals, we believe there are now more attractive opportunities in credit following the retracement in valuations.

### CHART 1: 2 YEAR VS 10 YEAR U.S. TREASURY YIELD SPREAD & 3 MONTH VS 10 YEAR U.S. TREASURY YIELD SPREAD



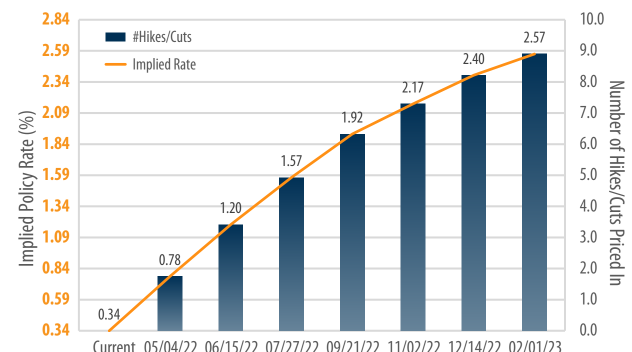

Source: Bloomberg, as of 3/31/2022

### CHART 2: U.S. TREASURY YIELD CURVE




Source: Bloomberg

### CHART 3: IMPLIED FEDERAL FUNDS RATE & NUMBER OF HIKES/CUTS




Source: Bloomberg

There can be no assurance that any of the trends and projections cited herein will continue or come to fruition.

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## FIXED INCOME OUTLOOK CONTINUED

As we progress through this economic cycle, we believe it's important to remember the timeless and sage advice, "Don't Fight the Fed." Investors seem to embrace the wisdom of this mantra in periods of robust monetary accommodation but appear to forget its importance when the Fed pivots to tighten financial conditions. Inflation is running significantly higher than the Fed's target rate, and to fight inflation the Fed has limited tools at their disposal other than the blunt instruments of persistently increasing interest rates and shrinking their balance sheet. However, while we continue to anticipate a challenging environment for long duration assets as the Fed normalizes its interest rate policy and economic growth slows, given our expectation for continued U.S. economic growth in the near term, we believe credit selection and yield curve positioning will be paramount in driving attractive risk adjusted returns in the bond market.

## SECTOR POSITIONING

### Ultra-Short Maturity

Given our expectation for a rapid increase in short-term interest rates over the next several Fed meetings, we believe ultra-short securities will exhibit lower volatility than other fixed income sectors. In addition, we expect ultra-short duration securities to deliver higher income as rates increase.

### Mortgage-Backed Securities

We maintain exposure to agency mortgage-backed securities (MBS) because we believe they have limited credit risk and can reduce overall risk profile given lower expected volatility and a lower correlation to corporate credit. We believe generic and index-based MBS are most at risk as interest rates increase and the Fed reduces its balance sheet. However, we believe our thesis is supported by hedging these risks coupled with more attractive valuations than last quarter and a fundamentally robust housing market.

### Treasury Inflation Protected Securities (TIPS)

While our view is for inflation to be persistently higher than the Federal Reserve's target inflation rate, inflation break-evens have increased in response to much stronger recent inflation prints. We do not believe TIPS break-evens will remain at current elevated levels and, when coupled with our expectation for higher interest rates on various parts of the yield curve, this could leave TIPS vulnerable to lower prices.

### U.S. Treasury Securities

Longer term Treasuries appear vulnerable in the face of a persistent hiking cycle and the potential for persistently high inflation. The Fed raised short term interest rates by 25 basis points (bps) in March and, in a hawkish shift, signaled willingness to hike at every meeting with some hikes as much as 50 bps through the end of this year. The Fed will also be focused on balance sheet reduction, which is anticipated to occur faster than the last quantitative tightening cycle. Given Treasuries' low yields and long durations, we believe they offer little protection from the anticipated path of the Fed.

### High-Yield Bonds

We believe high-yield bonds currently benefit from strong underlying fundamentals, low default rates, and a healthy economy. As interest rates have adjusted higher, credit spreads have widened offering investors some mitigation against rising rates. We believe high-yield bonds are now fairly priced relative to senior loans providing a potential attractive income stream for assuming subordinated credit risk. Given high-yield bonds' relatively short duration, wider spread and attractive income profile, it is an attractive opportunity to add to high-yield bonds, in our view.

### Senior Loans

Senior loan funds have posted 15 consecutive months of inflows because of corporate fundamentals remaining strong with low default rates and a healthy economy. Recently, due to escalating geopolitical tensions, bank loan spreads have widened, however, we believe that bank loans will benefit from the Fed's anticipated interest rate path and this recent spread widening has led to an attractive entry point.

### Investment Grade Corporate Bonds

We believe corporate balance sheets remain healthy and investment grade spreads are more attractive. Given the rapid move in the front end of the yield curve, we are more constructive on short-term corporates and we believe longer duration bonds are more exposed to interest rate risk. The intermediate term structure has flattened, and we believe investors are not well compensated to extend duration. We believe short-term corporate bond valuations appear very attractive with robust fundamentals and are less exposed to potentially higher long-term rates.

### Preferred Securities

The preferred securities market faces risks from inflationary pressures, rising rates and geopolitical conflicts. However, we remain constructive on preferreds as they have historically performed well during periods of rising short and long-term yields and wider current yield spreads offer a potential cushion against rising rates. The institutional $1000 par market, which is concentrated in variable rate coupon structures may continue to outperform most fixed rate coupon preferreds in a rising rate environment. Variable rate securities also stand to benefit from rising rates as benchmark rates reset higher. From a credit standpoint, preferred securities are generally concentrated in high quality issuers. We also believe U.S. and European banks are well capitalized to withstand current geopolitical risks as well as other major sectors including insurance, utilities and REITs which are relatively defensive in nature.

### Emerging Market Bonds

Emerging Markets' yields and spreads moved higher with investors pricing in more contagion from the Russian invasion of Ukraine. Central banks have aggressively hiked interest rates and there are signs of China easing on credit. While Fed tightening could weigh on Emerging Markets, we have observed periods where Emerging Markets perform well after a hiking cycle has initiated. While the impact of the Russian invasion on Ukraine increases uncertainty, Emerging Markets' local yields are attractive on a historical basis, and we remain exposed to countries with positive account balance surpluses.

### Municipal Fixed Income

Credit fundamentals are improving for most municipal bond sectors given healthy GDP growth, lower unemployment, significantly improved revenues, and hundreds of billions of federal dollars available through the Cares Act, $1.9 trillion ARPA and passage of the $550 billion infrastructure bill. We believe municipal bond valuations are much more attractive and the short end of the municipal yield curve to also be attractive while there is more risk in the 20+ years part of the municipal yield curve. We remain constructive in high-yield municipals with supportive credit fundamentals.